COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF THE SALEM TELEPHONE COMPANY, INC.) CASE NO. 91-217

O R D E R

On June 28, 1991, Salem Telephone Company, Inc. ("Salem") filed its application proposing adjustments in its rates and charges pursuant to KRS 278.180. On July 12, 1991, Salem was notified that its application was being rejected pursuant to 807 KAR 5:001, Section 2, due to certain filing deficiencies. On July 26, 1991, Salem responded to the Commission's deficiency notice and the application was accepted as filed with tariff sheets reflecting an effective date of August 26, 1991. On August 6, 1991, the Commission, pursuant to KRS 278.190, suspended the proposed tariff up to and including January 26, 1992. Subsequently, during the written discovery phase of this proceeding, Salem requested and was granted extensions of time in which to respond to Commission data requests. As a result of these extensions, on November 1, 1991, Salem notified the Commission that it waived the implementation of its proposed rates up to and including February 29, 1992.

Salem's filing indicated a total company revenue deficiency of $228,633; however, the actual increase requested was $165,620, $63,013 less than the computed full revenue deficiency. Salem stated it was not requesting its full revenue requirement because the resulting increase would put too much of a burden on its customers at one time.[1] The increase as proposed by Salem would result in an average increase to residential customers of 80.7 percent.

There were no parties requesting intervention in this proceeding; however, 12 customer protest letters were filed. On December 19, 1991, a public hearing was held at the Commission's offices in Frankfort, Kentucky. Salem's brief was filed on January 22, 1992 and responses have been submitted to all requests for information. On January 30, 1992, at the request of Salem, an informal conference between Salem and the Commission Staff was held.

This Order addresses the Commission's findings and determinations with regard to its investigation of Salem's revenue requirements and rate design. We have determined that no increase in rates is justified.

TEST PERIOD

Salem proposed and the Commission has accepted the 12-month period ending March 31, 1991 as the test period in this proceeding.

NET INVESTMENT RATE BASE

Salem proposed a net investment rate base of $1,434,118. This proposal was based on actual test-year-end account balances with the exception of the cash working capital component; cash

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[1] Response to Commission Order dated August 6, 1991, Item 59.

working capital was based on 1/8 of proforma operating expenses exclusive of depreciation and taxes.

<u>Deferred Taxes</u>

Salem's test-year-end balance sheet reflected a balance in Deferred Taxes-Other of $23,500. In its initial filing Salem did not include this item as a deduction in its calculation of rate base; however, upon further investigation into the nature of the deferred taxes, Salem determined that this balance was related to accelerated depreciation and that it appropriately should be a deduction from rate base.[2] The Commission has therefore reduced Salem's proposed rate base by $23,500.

<u>Cash Working Capital</u>

Salem proposed a cash working capital component calculated on the basis of the 1/8, or 45-day, formula. A cash working capital allowance, in appropriate instances, is approved in recognition of the fact that investor-supplied cash is needed to finance operating costs during the time lag before revenues are collected. The most accurate way to measure this need is a lead-lag study. However, these studies are costly and complex and such an undertaking would be impractical for a company this size. In lieu of a lead-lag study, this and many other commissions have used the 1/8 formula method. This method is based on 45 days of operating and maintenance expenses and is a widely accepted surrogate for a lead-lag study. However, this Commission has limited the

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2 Transcript of Evidence ("T.E."), pages 69-70.

application of the 1/8 method to exclude local exchange companies based on their advanced billing for local service. For example, in the most recent GTE South Incorporated ("GTE") rate proceeding,[3] the Commission, in disallowing a proposed cash working capital proposal by GTE, stated:

> The Commission, in past cases, has disallowed a cash working capital allowance based on GTE South's advanced billing for local service. Since GTE South bills its customers in advance for local service, there is no significant "lag" between providing service and collecting payment. The Commission, in this case, finds that GTE South has provided no new evidence to support the inclusion of a cash working capital allowance and in accordance with past practice, none should be included. Therefore, GTE South's proposed cash working capital allowance is denied.

Similarly, in South Central Bell Telephone Company's ("South Central Bell's") last general proceeding,[4] the Commission stated:

> Bell's inclusion of a cash requirement of $3,386,000 has been rejected and its rate base reduced by that amount since local service is billed in advance of service rendered and Bell has provided no substantive evidence to demonstrate its investment or capital needs for funds to support its daily operations.

These determinations reflect the typical treatment that the Commission has accorded cash working capital proposals by LECs. The Commission in fact did not include a cash working capital

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3 Case No. 10117, Adjustment of Rates of GTE South Incorporated, Order dated September 1, 1988, page 7.

4 Case No. 9160, Petition of South Central Bell Telephone Company to Change and Increase Certain Rates and Charges for Intrastate Telephone Service, Order dated May 2, 1985, page 6.

component in Salem's last rate proceeding, which concluded in August of 1980.

For these reasons, inclusion of the proposed cash working capital is unreasonable. The long-standing policy of the Commission is reasonable and Salem has not presented evidence which would justify a deviation from this policy. The proposed cash working capital allowance of $77,614 should be denied.

Prepaids/Material & Supplies

Salem proposed the inclusion of the test-year-end Material & Supplies balance of $13,194 in its calculation of rate base. The Commission has accepted this proposal and has additionally allowed $4,976 representing the test-year-end level of Prepayments. Salem did not propose the inclusion of Prepaids in rate base because it believed that this investment was fully considered in its formula approach to calculating working capital.[5] Since the Commission has rejected Salem's working capital formula, prepayments should be specifically recognized.

It should be noted that the Commission traditionally bases Prepayments/Material & Supplies on a 13-month average to avoid distortions due to unusual fluctuations. However, in this case there is no appreciable difference between test-year-end and 13-month average results, so it is reasonable to accept year-end balances in accordance with Salem's preference.

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5 Response to Commission Order dated October 10, 1991, Item 15(d).

Based upon the foregoing, the Commission has determined Salem's net investment rate base to be as follows:

Plant In Service	$3,046,000	
Accumulated Depreciation	(1,761,896)	
Net Plant		$1,284,104
Add:		
CWIP	68,644	
Materials & Supplies	13,194	
Prepayments	4,976	
Subtotal		86,814
Less:		
Deferred Taxes		(32,938)
Net Investment Rate Base		$1,337,980

REVENUES AND EXPENSES

The Commission has accepted Salem's proposed adjustments to revenues and expenses.[6] In addition, the Commission has made the following adjustments to Salem's cost of service:

Corporate Allocations

Salem is a wholly owned subsidiary of TDS Telecom, which is a business segment of Telephone and Data Systems, Inc. ("TDS"). Salem is one of three telephone companies owned by TDS in the Commonwealth of Kentucky, along with Lewisport Telephone Company, Inc. ("Lewisport") and Leslie County Telephone Company, Inc. ("Leslie County"). The three Kentucky companies are a component of the Southeast Region of TDS headquartered in Knoxville, Tennessee. Each telephone company owned by TDS operates as a stand alone entity.

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6 ($8,344) and ($5,300), respectively.

As a member of the TDS system, Salem is the recipient of direct charges and a pro-rata portion of the corporate overheads of its parent and other senior affiliates. Six affiliated companies directly charged or allocated a total of $213,134 to Salem during the test year. After consideration of adjustments, below-the-line bookings, and capitalizations, the total amount of affiliated charges Salem proposed to include in its cost of service was $197,486.

Following is a summary of test-year affiliated charges:

Affiliate	Amount
Southeast Region	$88,557
TDS-Telecom	34,082
TDS-Chicago (Corporate Headquarters)	19,011
TDS-Madison	12,541
TDS/CS (Computing Services)	36,781
American Communications Consultants, Inc.	22,162
	$213,134

Total operating expenses and taxes for Salem for the test period were $770,353. It is apparent from the above illustration that allocated and directly charged costs from affiliates to Salem comprise a significant portion of the cost of service of Kentucky ratepayers. In fact, 26 percent of Salem's proposed operating expenses consist of affiliated charges. To ensure that the rates to be charged by Salem are fair, just and reasonable, it is mandatory that this Commission determine the reasonableness of these affiliated costs.

The Commission takes note of the fact that in years immediately preceding the TDS acquisition in 1989, Salem achieved returns above its authorized level, maintained a comfortable cash position, and achieved excellent service ratings as measured by PSC service standard reports.[7] From a basic service perspective, Salem's residential ratepayers were receiving complete and adequate service at a rate of $9.41 per month. There has been no evidence presented of inadequate service and no evidence of demands for expanded services. Salem's customers were apparently satisfied. Upon TDS's acquisition, Salem began incurring affiliate charges at a rate exceeding $200,000 per year, or $125.00 per customer. Concurrently, Salem's operating expenses increased 40 percent, earnings plummeted and, eventually, a rate case was filed seeking to increase customer local service rates by over 80 percent. The Commission is extremely concerned with this scenario and has therefore carefully weighed the benefits derived by Salem's ratepayers versus the costs the ratepayers are being asked to bear.

Throughout this proceeding the Commission has attempted to specifically ascertain and quantify the benefits associated with the affiliate charges. For example, in response to Item 46 of the Commission's August 6, 1991 Order, Salem was asked to provide studies that show the cost/benefit of each service provided to Kentucky ratepayers by affiliates. Salem's response was "No cost/benefit studies have been prepared at this time for the Kentucky companies."

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7 T.E., Staff Exhibit 1.

Again in Item 14(c) of the Commission's October 10, 1991 Order this issue was addressed. Salem was asked to quantify the benefits that have accrued to Salem's customers in terms of quality of service improvement, reduction of future costs, etc. Salem again failed to quantify the benefits, but stated that "The benefits of having a management information system and experienced management to Salem's customers is [sic] primarily an unquantifiable intangible benefit," and concluded that "Salem Telephone Company's customers benefit from the planning and administration that these affiliates provide the company so it can continue to provide high quality telecommunications services."

Item 8 of the post-hearing requests asked Salem to quantify specific cost savings associated with the TDS acquisition. Salem's response did demonstrate and quantify specific benefits accruing to Salem's ratepayers. Therein Salem provided a schedule demonstrating the following specific savings that resulted from the acquisition of Salem by TDS:

Description	Pre-acq. Costs	Post-acq. Costs
Audit	$ 7,300	$ 2,010
Accounting	28,412	20,628
Legal Fees	1,500	0
CABS processing	2,400	1,800
Totals	$39,612	$24,438

With respect to the remaining charges, however, Salem did not provide a quantified benefit. Instead, Salem characterized other costs as an investment in an "integrated management team," and stated that the benefits of having a management information system and experienced management group supporting Salem and Salem's customers is largely an "unquantifiable intangible benefit." Salem argued that this experienced management would provide long-term cost savings and protect future revenue streams.

The Commission is concerned that immediate and substantial cost increases have occurred, but that, for the most part, immediate benefits have not been proven to exist. Nor has Salem adequately quantified expected "long-term cost savings or future revenue streams." In order to ensure the protection of Salem's ratepayers from unreasonable costs that do not provide a commensurate benefit, the burden must be on the company to demonstrate, prove, and quantify with specificity the benefit associated with each cost directly charged and/or allocated to Salem. With the exception of the savings supra, Salem has failed to do this. The Commission therefore finds that all test-year corporate charges, exclusive of the $24,438 of charges that reflected cost savings, should be disallowed. This accordingly reduces Salem's test-year operating expenses by $173,048.[8]

In order to include affiliate charges in cost of service, Salem and TDS have the burden of proving, demonstrating, and quantifying the specific benefit accruing to Salem's ratepayers as a result of each corporate charge. In future proceedings Salem should be prepared, through competent material documentation, to demonstrate that each affiliate charge: 1) is related to a service that is reasonably necessary for the provisioning of

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8 $197,486 - $24,438 = 173,048.

telecommunications service to its ratepayers; 2) is not duplicative of services available through its local workforce or resources; 3) is not duplicative of services rendered by other affiliates; 4) produces a tangible benefit to the ratepayers; and 5) is at or below the fair market value of the service provided.

Salem may demonstrate that the service is reasonably necessary for the provisioning of telecommunications service by showing that: 1) quality of service would suffer without the affiliated service; 2) its ability to comply with regulatory mandates would suffer without the service; 3) its administrative operations would suffer without the service; or 4) future operations of the company may suffer without the service.

Salem may demonstrate that the service is not duplicative of services available through its local workforce by showing that managers and employees on the local payroll are unable to perform the service themselves. Salem may demonstrate that the service is not duplicative of local resources by demonstrating that: 1) the service cannot be performed at the local level; or 2) the service can more efficiently and less expensively be done by an affiliate.

Salem may demonstrate that a service is not duplicative of services rendered by other affiliates by clearly differentiating any service provided by an affiliate from similar services provided by other affiliates. If engineering services are provided by more than one affiliate, Salem should provide sufficient detail to demonstrate that the service provided by one affiliate differs substantially from the service provided by others.

Salem may establish that a tangible benefit will or has accrued to the ratepayer by showing: 1) that the ratepayers have superior services or options as a result of the affiliated charge; 2) that Salem has experienced or will experience an overall reduction in costs as a result of the service with supporting quantification; or 3) that increased non-local service revenues have or will be generated with quantification.

Methods of establishing that the charge for the service rendered is at or below fair market value may be accomplished by demonstrating that: 1) the charge is at or below the cost of the same service on the open market; 2) the charge is equal to or below the cost similar utilities pay to their service companies; or 3) the cost of a particular service is at or below the cost incurred for that service prior to the acquisition of Salem by TDS.

These requirements <u>supra</u> will also be applied to Lewisport's and Leslie County's affiliated transactions in future rate proceedings.

<u>Director Fees</u>

In addition to their managerial salary compensation, the two former stockholders also received fees of $7,200 each for serving on Salem's board of directors. The Commission has determined that these fees represent part of the overall compensation paid by TDS for their Salem stock and, therefore, are unreasonable to be borne by the ratepayers.

In its letter of November 11, 1988 to the former stockholders wherein TDS offered to purchase all of the issued and outstanding shares of Salem stock, there was included a term whereby the former stockholders would be "elected" as directors for life and be paid a fee of $7,200 annually. The former stockholders accepted the TDS offer on December 10, 1988 and continue to serve as directors under the terms of the acquisition agreement. When asked whether the directors' fees were included in the sale package, Salem responded "Yes, that was part of the negotiation."[9] Also indicative that these director fees represent compensation for the stock is the fact that no other members of Salem's board receive a fee for their services.[10]

It is unfair to burden the ratepayers with incentives offered by TDS for acquisition of the Salem stock. Inasmuch as it was TDS that acquired the stock, TDS should pay for it. Inclusion of terms in acquisition offers that shift costs from the stock purchaser to the ratepayers will not be recognized as reasonable or fair in the setting of rates. The Commission has reduced operating expenses by $14,400 to exclude the test-year cost of the directors' fees.

<u>Wages and Salaries/FICA</u>

Salem indicated that it had recently been notified that its vice-president planned to retire effective February 1, 1992. This employee's test-year salary was $63,961. In conjunction with this retirement Salem has hired a new employee who will be paid a

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[9] T.E., page 36.

[10] Hearing data request, Item 4.

salary of $15,142. The net reduction in going forward salaries resulting from this personnel change will be $48,819.[11] Salem proposes to modify its cost-of-service proposal to recognize this reduction.[12] In recognition of this salary reduction, test-year operating expenses have been reduced by $48,819, and operating expenses reduced by $3,079 to recognize the reduction in FICA payroll taxes.[13] The total operating expense adjustment associated with this retirement is $51,898.

Pension Expense

In November of 1986, Salem initiated a pension with National Telephone Cooperative Association Pension Plan. Upon initiating this plan, Salem purchased past service benefits for each of its employees. This purchase, in effect, brought these employees to the status they would have occupied had they been in the plan since the time of their initial employment by Salem. In its letter dated September 5, 1988, Salem notified the Commission of this event and requested approval to book the $429,693 cost as a deferred charge to be amortized over 10 years.

On September 20, 1988, the Commission Staff issued a letter approving Salem's request. However, this letter was issued to grant approval of the accounting treatment for this expenditure

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11 T.E., page 46.

12 T.E., page 46.

13 ($53,400 - $15,142) X 6.2 percent + ($63,961 - $15,142) X 1.45 percent.

and is in no way binding upon the Commission in deciding its rate-making treatment.

The amortization of this non-cash item is improper for inclusion in current rates because it would require current ratepayers to bear costs properly attributable to ratepayers for the period of 1958, the date of the company's inception, to 1986. Salem stated, as of October 1986, the average years of service of Salem's employees was 27 years.[14] In fact, given that funds from prior earnings were available in 1986 to initiate the plan, it can be argued that Salem's previous ratepayers did fund this item. It would not be fair to the ratepayers of the 1990s to require them to bear this cost.

The Commission is in no way disparaging Salem's implementation of this pension plan. The Commission's responsibility is to set rates on a going forward basis and full recognition is provided for in the rates established herein to ongoing pension expenses associated with current employee services. Test-year operating expenses have been reduced by $41,250 to eliminate the prior years service amortization.

Employee Concessions

Salem maintains a policy that, as a part of overall compensation, each employee is provided free local exchange service. Foregone test-year revenues resulting from this policy were $753.[15] In establishing rates for local exchange companies

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14 T.E., page 98.

15 Response to Commission Order dated August 6, 1991, Item 26.

the Commission has maintained a policy that it is only reasonable to impute such foregone revenues back to the company so as not to require the ratepayers to bear this cost. In Salem's last rate proceeding the Commission applied this treatment in its final order:

> During the test period the Company allowed employee concessions amounting to $1,026 in lost revenue. The Commission has made an adjustment to increase test year revenue by this amount in accordance with its policy concerning employee concessions.[16]

Salem's position is that this method of compensating its employees results in a cost free benefit to the company and that equivalent compensation through salary would result in a greater burden on the ratepayers due to the associated payroll tax.[17] However, nothing in the record of evidence has changed the Commission's opinion that these concessions should not be borne by the ratepayers. The Commission has therefore increased Salem's test-year operating revenues by $753.

Manager Vehicle

As part of his overall compensation, Salem's president and manager is provided a company vehicle. Under Salem's policies the vehicle may be used for both business and personal uses. Salem states that the amount of personal use of the vehicle is

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16 Case No. 7782, Application of Salem Telephone Company for Authority to Increase its Rates for Telephone Service Rendered On or After July 1, 1980, Order dated August 29, 1980, page 3.

17 T.E., pages 58-59.

considered minor and no additional costs have been assigned to the manager's W-2 as additional compensation.[18]

Salem estimates that the amount associated with the manager's personal use of the vehicle recorded as operating expenses during the test year was $813.[19] Salem maintains that this expenses is an appropriate item to include in its cost of service because it should be considered as part of the manager's overall compensation,[20] but when asked to identify the benefits accruing to its ratepayers from nonbusiness uses of the vehicle, Salem responded "if you put it in terms of how they benefit from his nonbusiness use they probably don't receive much benefit."[21] The Commission has established that expenditures that do not provide a demonstrable benefit to the ratepayers should not be borne by them, but must instead be absorbed by the stockholders. Salem's test-year operating expenses have been reduced by $813 to remove costs associated with the manager's personal use of his company-provided vehicle.

Annual Audit

Salem proposed an adjustment of $1,500 to reflect a projected increase in the cost of its annual audit from the test-year level

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18 Response to Commission Order dated August 6, 1991, Item 49.

19 Response to Commission Order dated October 10, 1991, Item 9.

20 T.E., page 64.

21 Id.

of $4,500 to $6,000.[22] Salem subsequently determined that its actual test-year accruals for annual audit expense totaled $4,000,[23] and that a more appropriate level for the going forward projection for this expense is $2,200.[24] The Commission has reduced test-year operating expenses by $1,800.

<u>Rate Case Expense</u>

Salem proposed to amortize the estimated $15,000 cost of processing this rate case over 3 years, producing an adjustment to test-year operating expenses of $5,000. Subsequently, Salem increased its projected rate case expense to $25,000.[25] Salem explained that actual expenses had exceeded original estimates because it had not anticipated "the degree of data requests and the degree of complication" in this case.[26] In its filing of January 14, 1992, Salem reported that actual rate case expenses incurred as of January 7 were $27,988.[27]

The actual expense incurred is reasonable and operating expenses have been increased by $9,329 to reflect a three year amortization.

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22 Application Adj. K.

23 Hearing Data Request, Item 3.

24 T.E., page 80.

25 Response to Commission Order dated October 10, 1991, Item 19(c).

26 T.E., page 82.

27 Hearing Request, Item 5.

Income Taxes

Based upon the foregoing adjustments Salem's normalized state and federal taxes are $53,084. This level was determined based upon an effective state tax rate of 5.7539 percent and a federal tax rate of 34 percent. The interest deduction for tax purposes was synchronized as proposed by Salem.

ADJUSTMENTS SUMMARY

Based on the foregoing adjustments, the Commission finds Salem's adjusted test-period operations to be as follows:

	Test Year Actual	Adjustments	Test Year Adjusted
Operating Revenues	$ 701,689	$(7,591)	$ 694,098
Operating Expenses	(817,018)	287,180	(529,838)
Income Taxes	46,665	(99,749)	(53,084)
NOI	$(68,664)	$ 179,840	$ 111,176

COST OF COMMON EQUITY

Salem proposed a return on equity ("ROE") of 13.5 percent. Salem opined this level to be slightly lower than the mid-point of the rate approved for South Central Bell in the 1988 Incentive Regulation Plan and reasonable given the low level of equity in its capital structure.[28] Although Salem proposed an ROE of 13.5 percent, Salem's proposed rates produced a return of 3.5 percent. Salem does not believe a 3.5 percent return is reasonable, it is merely the result of its election to ask for a lessor increase

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28 Testimony of Michael A. LeaVesseur, page 16.

than the increase it actually needed to reach its full revenue requirement.[29]

Salem argues that a 13.5 percent ROE is reasonable given the rates of return authorized in other states and particularly in light of the 27 percent equity in its capital structure.[30] Yet, the record contains no showing to support Salem's claim relative to returns authorized in other states. Moreover, Salem did not attempt to perform any financial analysis in arriving at its proposed return.[31]

Salem does have a low level of equity in its capital structure and this would tend to infer a higher level of risk. Salem's parent, on the other hand, has a strong equity position in its capital structure - 77 percent. One of the benefits that should be accorded Salem by its parent is greater access to the capital markets. Salem though is financed chiefly by long-term debt from the Rural Electrification Administration. This decreases the inherent level of risk to Salem.

The South Central Bell return which Salem uses as a test of reasonableness is not appropriate. One might debate whether South Central Bell and Salem are even comparable companies for comparison. In any event, economic conditions today are much different from those in 1988. Salem is not being considered for

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29 T.E., page 44.

30 T.E., page 141.

31 T.E., page 142.

an experimental regulatory rate plan. The return authorized for Salem today must be commensurate with returns on other investments in other businesses with corresponding risk, sufficient to support its credit and allow it to attract new capital.

The Commission, having considered all of the evidence, including current economic conditions, finds that the cost of common equity is within a range of 11.75 percent to 12.25 percent. Within this range, an ROE of 12.0 percent will best allow Salem to attract capital at a reasonable cost and maintain its financial integrity to ensure continued service and to provide for necessary expansion to meet future requirements.

This equity determination produces an overall cost of capital of 5.068 percent.

REVENUE REQUIREMENTS

Based upon the Commission's findings and determinations, Salem has a revenue sufficiency of $70,332. Following is the Commission's calculation of this sufficiency:

Net Investment Rate Base	$1,337,980
X Rate of Return	5.068%
Required Operating Income	67,809
- Adjusted Operating Income	111,176
NOI Sufficiency	43,367
X Tax/Gross-Up	1.6218
Revenue Sufficiency	$ 70,332

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rate of return determined herein is fair, just, and reasonable and will provide for the financial obligations of Salem with a reasonable amount remaining for equity growth.

2. The rates proposed by Salem would produce revenue in excess of that found reasonable and should be denied based upon KRS 278.030.

IT IS THEREFORE ORDERED that the rates proposed by Salem be and they hereby are denied and the rates in Salem's current tariff shall remain in effect.

Done at Frankfort, Kentucky, this 28th day of February, 1992.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director